

Multistate Tax Commission



Hearing Officer's Report

Recommendation Concerning Proposed Model Affiliate Sales Tax Nexus Statute

April 15, 2005

I. Introduction.

The Sales and Use Tax Subcommittee of the Multistate Tax Commission's Uniformity Committee suggested work on an affiliate nexus proposal at its October 14, 2002 meeting. The Executive Committee at its October, 17, 2002, meeting followed the recommendation and approved affiliate nexus as a priority project directing staff to begin work on a draft statute that would be a composite of the Arkansas and Minnesota laws and pending California legislation. Staff began work on a draft statute in consultation with the Uniformity Committee. A draft was presented to the Executive Committee at its January 17-17, 2003 meeting. The Executive Committee decided that the draft did not present sufficient guidance for the states and directed the staff to suspend further work on the project and to answer inquiries on the subject by providing copies of the various state affiliate nexus laws.

Subsequently, the Sales and Use Tax Work Group of the Multistate Tax Commission's State Tax Compliance Initiative raised the issue of a model affiliate sales tax nexus statute or regulation. The Work Group described the issue in its March 2004 Report as follows:

States must find ways to enforce the collection of use tax by educating and encouraging remote sellers. One approach to solving this problem is in "affiliate nexus" statutes. What is "affiliate nexus?" Some businesses believe they may get around the responsibility of use tax collection by forming many separate entities to conduct business. These businesses assume that as long as the entity which actually makes the sale does not have nexus with the state, the business is not responsible for use tax collection. An affiliate nexus statute would clarify that a vendor must collect the tax if that vendor is owned by or owns a similar business that does have nexus within the state in which the vendor is conducting business. This type of statute would require the dot.com side of most brick and mortar stores to collect the tax on its sales even if it is a separate corporate entity.

The Report noted that several states had already adopted an affiliate nexus statute, and a few others were considering adoption. It concluded with this recommendation:

It is the recommendation of the work group that the Uniformity Committee of the Multi-state Tax Commission be assigned to develop a model affiliate nexus statute or regulation for consideration by the states. The development of the uniform statute could be placed on a fast track using the statutes of states that have this provision as a working model and base. Once developed, the statute could be referred to the individual states for adoption or consideration. All states participating in this effort would actively promote adoption of the uniformity proposal immediately upon its completion. If most states had this provision, vendors' collection responsibilities would be clarified, compliance from affected businesses would be greater and the risk from business reorganization to limit nexus exposure would be reduced.

This proposal is also consistent with the Commission's recommendation, adopted in the Federalism at Risk Report, to preserve the viability of state sales and use taxes by strengthening sales and use tax nexus standards to better reflect current business practices.

In response to the recommendations of the State Tax Compliance Initiative, the Executive Committee at its April 29, 2004, meeting adopted the recommendation that the Commission develop a uniform affiliate nexus statute and referred development to the Uniformity Committee. The Sales and Use Tax Subcommittee began development of a model statute that hewed as closely as possible to the provisions of the affiliate nexus statutes already in place.

At its November 9, 2004 meeting the Sales and Use Tax Subcommittee approved the draft proposal and recommended it to the full Uniformity Committee. The full committee approved the proposal the same day and referred it to the Executive Committee with the recommendation that it be referred to public hearing. The Executive Committee at its November 11, 2004, meeting approved the draft and referred it to a public hearing.

The Executive Director of the Commission appointed Frank D. Katz, General Counsel, to act as Hearing Officer and recommended multiple hearings. An initial hearing was scheduled in Oakland, CA with the intent of holding subsequent hearings in Chicago and New York. When the attendance at the first hearing was sparse, it was decided to hold only one other hearing, and do it in Washington, DC where the greatest attendance could be expected. The public was also offered the opportunity to dial into the Washington DC hearing, and a number did so.

II. The Proposal.

The purpose of the affiliate nexus proposal is to level the playing field for application of sales and use tax to consumer purchases within a state. A customer purchasing a widget at a retail store in a state will pay sales tax on the purchase. If that retail outlet sets up a separate corporate affiliate to sell the same widget from a remote location using the Internet, that out-of-state remote sales affiliate can assert it has no physical presence under the substantial nexus standard of *Quill Corp. v. North Dakota* and therefore may not be required to collect use tax from the purchaser.

The proposed uniform affiliate nexus statute simply lays out the circumstances under which the relationship between an out-of-state remote sales affiliate and the in-state retailer provides a substantial nexus for the out-of-state affiliate sufficient to require it to collect use tax.

- The two entities must be related parties and must either use identical or substantially similar names, trade names, trademarks, or goodwill to develop, promote, or maintain sales, or the in-state business must provide services to, or that inure to the benefit of, the remote affiliate relating to developing, promoting or maintaining the in-state market.
- The two entities are related parties if they meet the requirements of any one of three IRC sections concerning corporations (§§ 267, 318 or 1563) or if both entities are treated as partnerships and one owns directly, indirectly, beneficially or constructively at least 50% of the other.

States that have adopted affiliate nexus statutes generally rely on the same relational aspects—using similar names or having an in-state affiliate assist the remote seller to establish or maintain a market in the state. The statutes reference one of the three IRC sections to determine whether the entities are related parties. Referencing all three seems to be the most straightforward, and most inclusive, way of describing the necessary connection.

The Proposal is attached to the Notice of Public Hearing in Exhibit C.

III. Summary of Written Responses. None were received.

IV. Public Comment at Hearings

At the January 4, 2005 hearing in Oakland California, the proposal was described but no substantive comment was offered.

At the March 29, 2005 hearing in Washington DC, several people made comments.

Diann Smith, General Counsel of the Council on State Taxation (COST) began by saying the proposal was inappropriate and COST opposed it. She noted four issues.

1. The proposal is overbroad and goes beyond *Quill* and *Scripto*.
2. The proposal is unnecessary as the dot.com era is over, and bricks and mortar retailers are no longer following the business model of establishing an Internet affiliate to sell tax free into a state. Moreover, to the extent that the proposal does reflect aspects of Supreme Court cases, it is unnecessary as those cases control.
3. The proposal is uncertain as to whether it is a statute or a regulation.
4. The proposal is ill-advised as the Streamlined Sales Tax Project is the better way of handling the issue of remote sellers.

Ms. Smith acknowledged States' concern about use tax collection and the physical presence requirement. The pivotal point in *Scripto* and *Tyler Pipe*, she suggested, was the intentional use of the in-state marketing efforts to benefit the out-of-state vendor, and, as the Court pointed out in *Miller Brothers*, the in-state activity cannot be accidental or incidental with regard to establishing the market for the out-of-state vendor. Mere use of the same name alone may not be enough in all cases, she argued. There must be some similarity of product, some market connection. If the Jones Company sells one product at its stores in a state, the mere fact that a related party from outside the state sells a completely different product to a completely different market under the same Jones name does not provide the relationship justifying the finding of nexus. With regard to the provision of service by the in-state company to the out-of-state affiliate, merely inuring to the benefit of the out of state affiliate is not enough under the *Bloomingtons by Mail* and *SFA Folio* cases. The in-state company must do something specifically to help the out-of-state affiliate. Ms Smith also suggested that a *de minimis* provision in the statute would be helpful.

As to whether any proposal would be appropriate at this time, Ms. Smith noted that this issue is currently being litigated. The California decisions on this issue were very fact specific and don't seem amenable to the kind of generalization proposed in the model statute.

COST recommended that the MTC not pursue this proposal at this time as it would simply create controversy. Ms. Smith suggested that the process used in the MTC Unitary Business Definition recommended regulation was a more appropriate model, where the Commission derived its language from all of

the relevant cases and then listed scenarios. The nexus proposal, if pursued, would benefit from similar treatment, a listing of scenarios that provide nexus. Finally, Ms. Smith noted that lots of other kinds of contact create nexus. Addressing only the limited circumstances covered by the proposal seems to overemphasize one situation.

Jeff Friedman of the law firm of Sutherland, Asbill and Brennan asked whether it was the intention of the Commission to propose a statute that was consistent with recent state tax cases or one that goes beyond the holdings in those cases. If the intention is to be consistent, the Commission would do well to use the same terminology used in those cases and to offer indicia of nexus. He frowned down on the “kitchen-sink” approach to defining who related parties are by reference to three different IRC sections. Diann Smith noted that she had not received any comment from members on the related party definitions in Section B.

Kendall Houghton, also with the Sutherland firm, suggested that the proposal be amended to allow a Tax Commissioner to exclude application of the provision to certain facts if they do not meet constitutional standards. Jeff Friedman suggested a third paragraph to Section A that would require that “the totality of the facts and circumstances demonstrates the existence of constitutional nexus.”

Jeff Friedman gave a hypothetical that he believes shows how the proposal as currently written would go beyond what was intended. Company A with presence only in State A manufactures consumer products. It sells these products to many retail stores in many states, including in State B. It subsequently acquires a retail chain, which has long been a customer, with stores in State B. Both before and after the acquisition, the retail chain sometimes specially displays A’s products at the end of an aisle. It is hard to see, Mr. Friedman said, how the mere display of the product provided sufficient services to A to provide nexus under *Scripto* before acquisition, or why becoming an affiliate of A would make a difference.

Andy Schoettle of the University of Minnesota echoed the suggestion of a *de minimis* provision and suggested a threshold be included to exclude small and perhaps even medium-sized businesses.

V. Hearing Officer Recommendations

The proposed model affiliate nexus statute was not intended to plow new ground. It was intended to put into statute or regulation, at a state’s choice, well-established constitutional standards of nexus adopted by the U.S. Supreme Court in *Scripto* and *Tyler Pipe*. Those standards provide that a com-

pany that uses a third party to develop, promote and maintain a market in a state, which that company then exploits by selling products to customers in that state, has constitutional nexus. The physical presence of that third party in the state is attributed to the company, meeting the physical presence requirement of *Quill Corp v. North Dakota*. In *Scripto*, the Scripto Co. was paying the third party as an independent contractor to gain its help in marketing. In the proposal, the related-party link provides the motivation for the in-state affiliate to intentionally aid the out-of-state affiliate creating nexus under the cases.

Whether the provision constitutes an accurate reflection of current law, or somehow goes beyond it, seems to depend on where one sits. It would be surprising if there were not some circumstance which might fit the literal words of the proposed statute, but go beyond what was intended and maybe even what is constitutional. But it would also be surprising if auditors and tax administrators mindlessly insisted on apply the statute in those circumstances. Indeed, there are probably very few statutes that cannot be applied in an unconstitutional manner. Adding a sentence that says don't apply this statute unconstitutionally seems unnecessary.

To some extent, there may well be validity to the objection that the business model this proposal speaks to is no longer the paradigm. Affiliates seem to have realized that the loss of the synergy of cooperative cross-marketing is too big a price to pay for the avoidance of state taxes. And yet, the business model still exists and states are still enacting affiliate nexus statutes; better their enactments be uniform.

Diann Smith is correct that items marketed by the in-state affiliate must further the marketing of items with the same or similar names by the out-of-state affiliate. The in-state marketing of Jones tires may provide no substantial help to the out-of-state affiliate's marketing of Jones mascara. An added phrase that would answer this concern would be to require that the same or similar name promotes "sales of the same or similar products or services." There are circumstances, however, where a trade name or the trademark is so renowned that its use in connection to *any* product will give that product a huge marketing boost. Moreover, the requirement in the proposal as written that the same or similar name is used "to develop, promote, or maintain sales" already provides the causal relationship that Ms. Smith is seeking.

Finally, the idea of *de minimis* thresholds makes very good sense. The Commission embraced thresholds in its factor presence nexus standards and they are probably appropriate here. In selecting an appropriate threshold, we should seek a readily ascertainable sales amount. The question is whether the threshold should be a national one or a state-by-state threshold.

I recommend the addition of a Section C with either a state threshold:

C. The provisions of this [statute] [regulation] shall not apply to an out-of-state vendor that had sales in this State in the previous year in an amount of less than \$_____.

or a national threshold:

C. The provisions of this [statute] [regulation] shall not apply to an out-of-state vendor that had nationwide sales in the previous year in an amount of less than \$_____.

With that modification, your Hearing Officer recommends referring the proposal to a Bylaw 7 Survey.

Respectfully submitted April 15, 2005,

Frank D. Katz

Exhibits Attached to the Report of the Hearing Officer on the
Proposed Model Affiliate Sales Tax Nexus Statute

Exhibit A: Memorandum of Appointment of Hearing Officer

Exhibit B: Notice of Public Hearing.

Exhibit C: Certificate of Loretta King attesting to proper notice of hearing.

Exhibit A – Appointment of Hearing Officer



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

Memorandum of Appointment of Hearing Officer

To: Record of the Hearing on Affiliate Nexus Proposal

From: Dan R. Bucks, Executive Director

Date: December 17, 2004

Re: Appointment of Hearing Officer for Affiliate Nexus Proposal

The Executive Committee of the Multistate Tax Commission approved at its meeting held November 12, 2004, the conduct of a public hearing on an Affiliate Nexus Uniformity Proposal. Pursuant to that action and the Multistate Tax Compact, I hereby appoint Frank D. Katz, General Counsel, as Hearing Officer for this proposal. I further request that he proceed with the conduct of this hearing.

Dan R. Bucks, Executive Director

Exhibit B – Notices of Hearings

[post card notice]



NOTICE OF PUBLIC HEARINGS
Regarding
Proposed Model Affiliate Sales Tax Nexus Statute

The MULTISTATE TAX COMMISSION will conduct three public hearings to obtain comments from interested parties on a Proposed Model Affiliate Sales Tax Nexus Statute setting forth the circumstances under which an out-of-state business making sales into a state has nexus for sales taxes based on actions of an affiliate in the state. The Proposal is appended to this Notice as Exhibit A.

The first hearing on the Proposal is scheduled for:

TUESDAY, JANUARY 4, 2005, 1:00 P.M.
Oakland State Office Building
1515 Clay Street, Suite 306
Oakland CA 94612

Additional hearings will be scheduled in New York and Chicago in February and March.

All comments received as part of the hearing process will be set forth in a hearing officer's report that will be submitted to the MTC Executive Committee. The Committee will read what you say and then will consider the Proposal for appropriate action. *See* MTC's Uniformity Recommendation Development Process step seven, available at www.mtc.gov/uniform/9steps.htm

The hearing officer for this matter is Frank D. Katz. Please submit all questions, comments and correspondence regarding this hearing matter to: Frank D. Katz, Multistate Tax Commission, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (505) 982 4351, Fax: (505) 982 4379, E-mail: fkatz@mtc.gov

All interested parties are invited to participate in these public hearings. Parties wishing to make formal oral presentations are requested to notify the hearing officer in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged. They may be submitted at any time prior to or on the hearing dates or by such later date as may be announced at the closing of the public hearings. Interested parties may participate by telephone. Please contact the hearing officer for specific instructions on how to connect by telephone.

Exhibit A

Multistate Tax Commission

Proposed Model Affiliate Sales Tax Nexus Proposal

November 11, 2004

As approved by the MTC Executive Committee for Public Hearing

A. An out-of-state vendor has substantial nexus with this State for the collection of use tax if both of the following apply:

- (1) the out-of-state vendor and an in-state business maintaining one or more location within this State are related parties; and
- (2) the out-of-state vendor and the in-state business use an identical or substantially similar name, tradename, trademark or goodwill to develop, promote, or maintain sales, or the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market.

B. Two entities are related parties under this section if they meet any one of the following tests:

(1) both entities are component members of the same controlled group of corporations under section 1563 of the Internal Revenue Code;

(2) one entity is a related taxpayer to the other entity under the provisions of section 267 of the Internal Revenue Code;

(3) one entity is a corporation and the other entity, and any party for which section 318 of the Internal Revenue Code requires an attribution of ownership of stock from that party to the entity, owns directly, indirectly, beneficially, or constructively at least 50 percent of the value of the outstanding stock of the corporation; or

(4) one or both entities is a limited liability company, partnership, estate, or trust, none of which is treated as a corporation for federal income tax purposes, and such limited liability company, partnership, estate, or trust and its members, partners or beneficiaries own in the aggregate directly, indirectly, beneficially, or constructively at least 50 percent of the profits, capital, stock, or value of the other entity or both entities.

[post card notice]



NOTICE OF SECOND PUBLIC HEARING

Regarding Proposed Model Affiliate Sales Tax Nexus Statute

The MULTISTATE TAX COMMISSION will conduct a second public hearing to obtain comments from interested parties on a Proposed Model Affiliate Sales Tax Nexus Statute setting forth the circumstances under which an out-of-state business making sales into a state has nexus for sales taxes based on actions of an affiliate in the state. The Proposal is appended to this Notice as Exhibit A.

The second hearing on the Proposal is scheduled for:

TUESDAY, MARCH 29, 2005, 1:00 P.M. EASTERN

Hall of the States, Suite 231
444 North Capitol St NW
Washington, DC

All comments received as part of the hearing process will be set forth in a hearing officer's report that will be submitted to the MTC Executive Committee. The Committee will read what you say and then will consider the Proposal for appropriate action. See MTC's Uniformity Recommendation Development Process step seven, available at www.mtc.gov/uniform/9steps.htm

The hearing officer for this matter is Frank D. Katz. Please submit all questions, comments and correspondence regarding this hearing matter to: Frank D. Katz, Multistate Tax Commission, 444 N. Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538, Phone: (505) 982 4351, Fax: (505) 982 4379, E-mail: fkatz@mtc.gov

All interested parties are invited to participate in these public hearings. Parties wishing to make formal oral presentations are requested to notify the hearing officer in writing at least two (2) working days prior to the hearing date. Written comments are acceptable and encouraged. They may be submitted at any time prior to or on the hearing date or by such later date as may be announced at the closing of the public hearing. Interested parties may participate by telephone by dialing 1-719-785-9325, then the access code of 9824351. You will then be asked to state your name and press the # key. Please contact the hearing officer with any additional questions on how to connect by telephone.

Exhibit A
Multistate Tax Commission
Proposed Model Affiliate Sales Tax Nexus Proposal

November 11, 2004

As approved by the MTC Executive Committee for Public Hearing

A. An out-of-state vendor has substantial nexus with this State for the collection of use tax if both of the following apply:

(1) the out-of-state vendor and an in-state business maintaining one or more location within this State are related parties; and

(2) the out-of-state vendor and the in-state business use an identical or substantially similar name, tradename, trademark or goodwill to develop, promote, or maintain sales, or the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market.

B. Two entities are related parties under this section if they meet any one of the following tests:

(1) both entities are component members of the same controlled group of corporations under section 1563 of the Internal Revenue Code;

(2) one entity is a related taxpayer to the other entity under the provisions of section 267 of the Internal Revenue Code;

(3) one entity is a corporation and the other entity, and any party for which section 318 of the Internal Revenue Code requires an attribution of ownership of stock from that party to the entity, owns directly, indirectly, beneficially, or constructively at least 50 percent of the value of the outstanding stock of the corporation; or

(4) one or both entities is a limited liability company, partnership, estate, or trust, none of which is treated as a corporation for federal income tax purposes, and such limited liability company, partnership, estate, or trust and its members, partners or beneficiaries own in the aggregate directly, indirectly, beneficially, or constructively at least 50 percent of the profits, capital, stock, or value of the other entity or both entities.

Exhibit C - Certificate of Loretta King



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Frank D. Katz, General Counsel and Hearing Officer for MTC Uniformity
Proposal Proposed Model Affiliate Sales Tax Nexus Statute.

From: Loretta King, Administrative Assistant

Date: April 7, 2005

Subject: Certification of mailing of "NOTICE OF PUBLIC HEARINGS
Regarding Proposed Model Affiliate Sales Tax Nexus Statute"

In compliance with the Multistate Tax Commission Bylaw 7, I mailed two postcard notices entitled "Notice of Public Hearings Regarding Proposed Model Affiliate Sales Tax Nexus Statute" to the names on the mailing lists maintained by the MTC, the first on December 1, 2004, and the second on February 15, 2005.